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INVESTMENT PERSPECTIVES

The case for active emerging market small-cap strategies

Active small-cap equity managers benchmarked to the MSCI Emerging Markets (EM) Small Cap Index have generated attractive excess returns over shorter and longer investment horizons.

Emerging market small-cap equities offer diversification and greater access to domestically focused businesses that may face lower trade and supply chain disruptions than larger companies.

We expect emerging market small-cap equities will outperform large-cap stocks in a recovery, making dedicated allocations to this asset class a timely consideration today.

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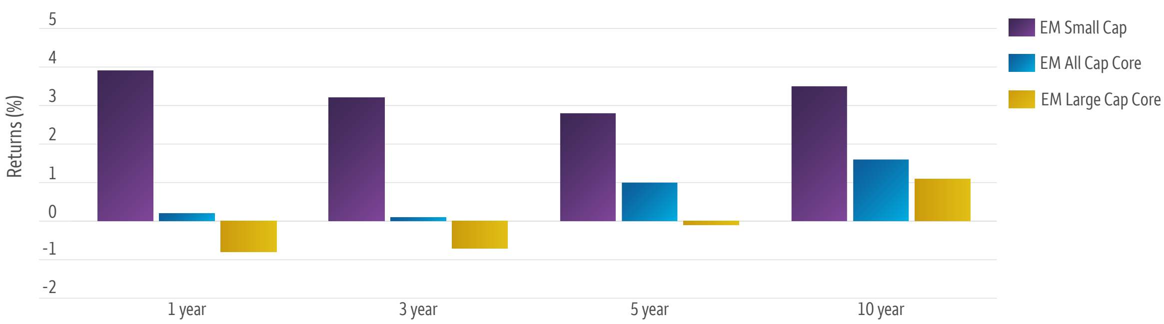
We think investors have too often overlooked dedicated small-cap strategies when building their strategic allocations to emerging market equities. According to data collected from eVestment Alliance, emerging market equity strategies benchmarked to the MSCI EM Small Cap Index represented only 2.2% of the total assets allocated to all emerging market equity strategies at year-end 2019. This leaves considerable room for global investors to increase allocations to this space. We expect that many small-cap companies may benefit as the world recovers from the impact of the coronavirus. This may provide investors an attractive entry point, as we lay out in this paper.

Similar to small-cap stocks in other global equity markets, small caps in emerging markets have relatively little sell-side research coverage in comparison to their larger counterparts, which we believe contributes to security-level mispricing and stronger selection opportunities. In fact, Figure 1 shows that the median active emerging market small-cap equity manager has consistently outperformed the MSCI EM Small Cap Index for 1-, 3-, 5-, and 10-year periods ending 31 March 2020, adding significantly more value than the corresponding manager in the more traditional all-cap or large-cap universes.

Figure 1: Trailing active manager median annualized excess returns ending 31/3/2020



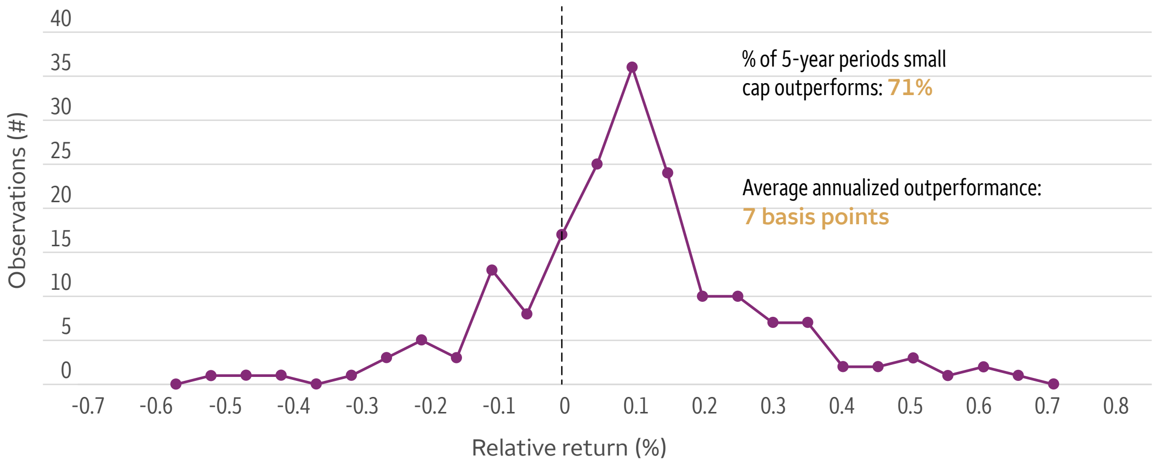
Source: eVestment Alliance. Shows eVestment Alliance universe median U.S. dollar, gross of fees, manager excess return over the most common universe benchmark. Specifically, EM Small Cap captures the Global Emerging Markets Small Cap Equity universe versus the MSCI EM Small Cap Index-ND. EM All Cap Core captures the Global Emerging Markets All Cap Core universe versus the MSCI EM Index-ND. EM Large Cap Core captures the Global Emerging Markets Large Cap Core universe versus the MSCI EM Index-ND.

Past performance is not a reliable indicator of future results.

The opportunity for alpha generation is attractive in itself, but there are also favorable portfolio diversification attributes of this asset class for global investors. Over the past 20 years ending 31 March 2020, the MSCI EM Small Cap Index realized lower return correlations against major developed market indices than that achieved by the MSCI EM Index—specifically, 0.73 versus 0.78 against the S&P 500 Index and 0.84 versus 0.87 against the MSCI EAFE Index.

In addition to these positive portfolio risk attributes, it is also noteworthy that the MSCI EM Small Cap Index outperformed the MSCI EM Index in 71% of all 5-year periods, rolling monthly, within the 20-year period. Figure 2 illustrates a frequency distribution of relative returns over all 5-year periods, with positive readings indicating outperformance of the MSCI EM Small Cap Index. The average annualized outperformance of these periods was 7 basis points, or 0.07%.

Figure 2: Frequency distribution of 5-year annualized relative returns, rolling monthly*



Sources: eVestment Alliance and WFAM. *The chart presents the frequency distribution of 5-year annualized relative returns rolling monthly of the MSCI EM Small Cap Index versus MSCI EM Index for the 20 years ending 31 March 2020.

Past performance is not a reliable indicator of future results.

Small caps dramatically outperformed in the recovery following the global financial crisis

Small caps have tended to underperform during large drawdowns, as experienced during the global financial crisis and more recently during the global equity market downturn that took place in the first quarter of 2020. However, emerging market small caps outperformed dramatically during the initial recovery from the 2008–2009 financial crisis and we would expect them to do so in any eventual recovery from the current coronavirus crisis.

Table 1: Historical performance surrounding market drawdown (%)

	2008 (global financial crisis)	2009 (initial recovery)	2020 (coronavirus crisis)
MSCI EM Index	-53.33	78.51	-23.60
MSCI EM Small Cap Index	-58.33	113.79	-31.37

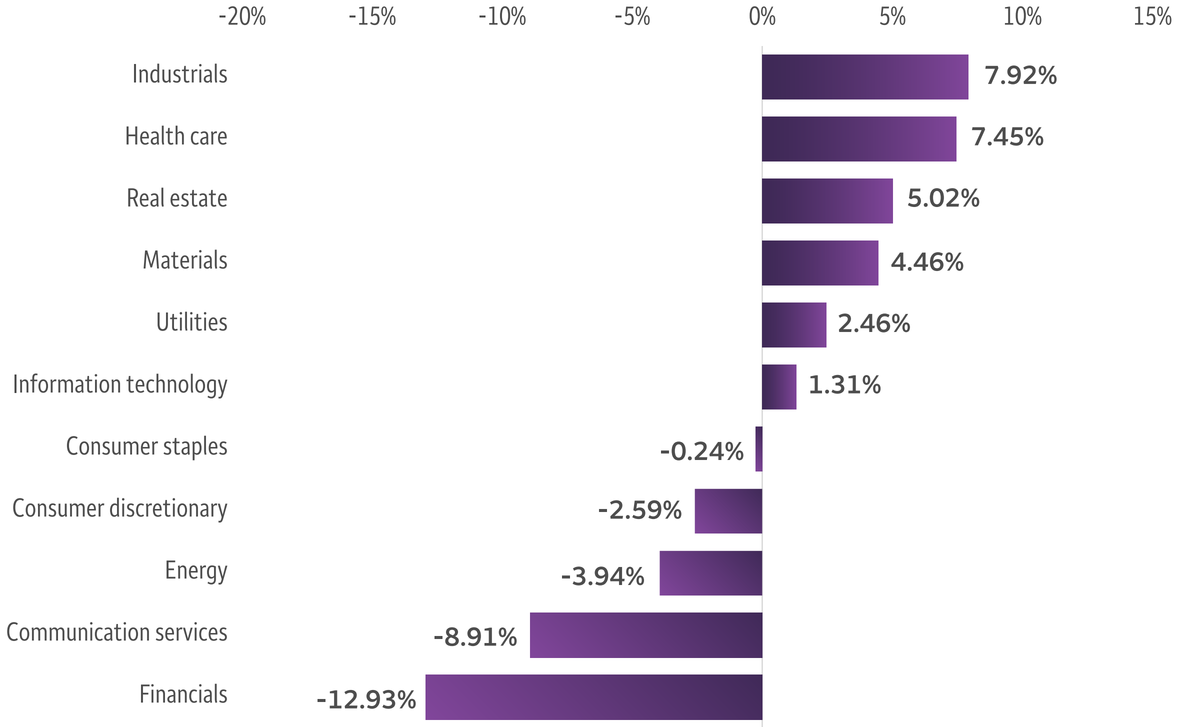
Source: eVestment Alliance; shows full-year performance for 2008 and 2009 and year-to-date performance through 31/3/2020

Past performance is not a reliable indicator of future results.

Small caps offer investors greater exposure to domestic growth opportunities

The MSCI EM Small Cap Index has a relatively large concentration of domestically focused companies, which tend to have outsized presence in certain sectors. The industrials, real estate, health care, and consumer discretionary sectors constitute 44.6% of the MSCI EM Small Cap Index versus only 26.8% of the MSCI EM Index as of 31 March 2020.

Figure 3: Relative sector weights of MSCI EM Small Cap Index versus MSCI EM Index as of 31/3/2020

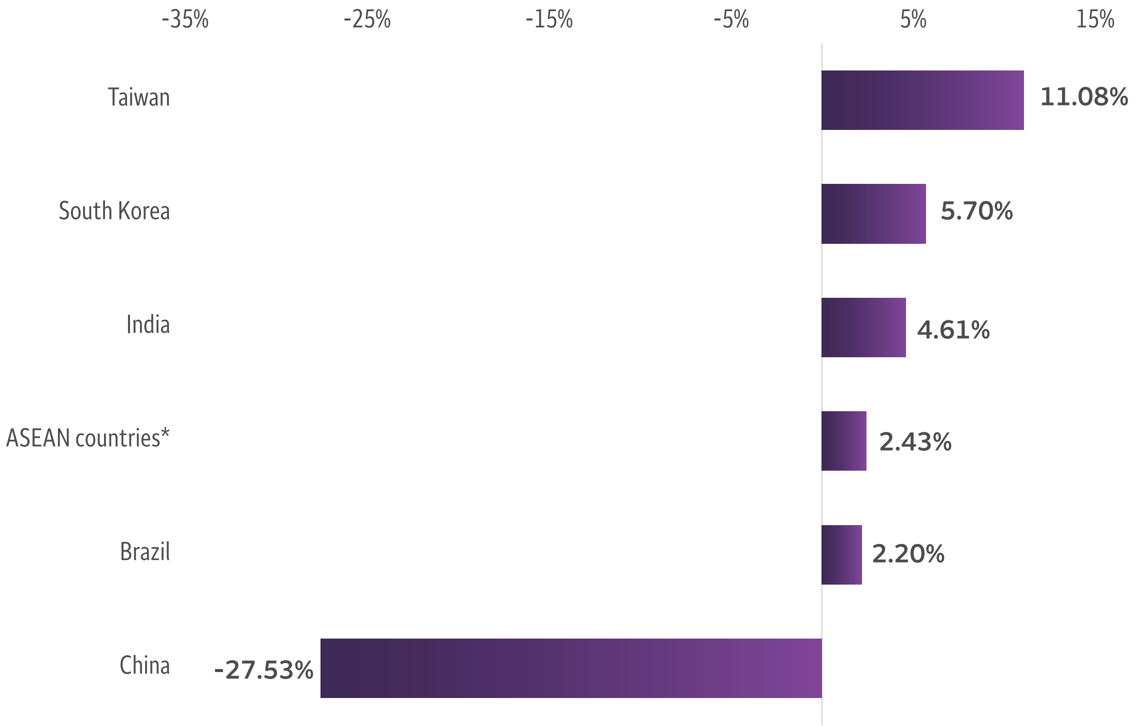


Source: MSCI

A shift of supply chains away from China could lead to emerging market small-cap outperformance

We think there is an increasing likelihood that major supply chains will be diversified away from China in a post-coronavirus world, exacerbating the fallout from trade tensions. As China's weight in the MSCI EM Small Cap Index (13.1%) is significantly lower than its weight in the MSCI EM Index (40.6%), investors may reduce some of the associated supply chain disruptions affecting China by pursuing strategies that reflect these country allocations. Within emerging markets, most surveys point to Southeast Asia and India as likely beneficiaries of such shifts, aided by labor cost advantages. Longer term, we believe asset allocators should give some thought to the secular shifts in global supply chains that may happen over the next decade. This will likely lead to a new host of winners and losers. We think that nimble managers who can identify the winners early may benefit the most.

Figure 4: Relative country weights of MSCI EM Small Cap Index versus MSCI EM Index as of 31/3/2020



Source: MSCI
*ASEAN countries include Indonesia, Malaysia, Philippines, and Thailand.

The MSCI EM Index is concentrated with the top 10 constituents making up 28.47% of the index by value. In contrast, the top 10 constituents of the MSCI EM Small Cap Index represent only 3.35% of the index. Investors who want to diversify their emerging market exposures away from the large names that dominate the MSCI EM Index can do so by increasing allocations to emerging market small-cap strategies.

Table 2: The MSCI EM Small Cap Index is less concentrated than the MSCI EM Index

Company name	MSCI EM Index weight (% as of 31/3/2020)	Company name	MSCI EM Small Cap Index weight (% as of 31/3/2020)
Alibaba Group Holding	7.08	Silergy Corp.	0.48
Tencent Holdings	5.89	Hanjin Kal Corp.	0.44
Taiwan Semiconductor Mfg	4.68	Seegene	0.34
Samsung Electronics Co.	3.92	Macronix International	0.31
China Construction Bank	1.65	Parade Technologies	0.31
Naspers	1.33	Techno Electric & Mach	0.30
Ping an Insurance	1.15	Chroma ATE	0.30
China Mobile	0.96	SIMPLO Technology Co.	0.29
ICBC	0.93	Qatar Gas Transport (Nakilat)	0.29
Reliance Industries	0.88	Jubilant FoodWorks	0.28
Total	**28.47**	**Total**	**3.35**

Source: MSCI

Generational changes in the management of family-owned enterprises could provide alpha opportunities for investors

A large portion of small-cap companies in emerging markets are privately owned, with many families owning more than 50% of the float. We believe the next decade will see a generational change in management. While some families will still be involved in running the business, others will hire professional management and oversee their interests through active representation at the board level as majority investors. Professionalization of management should lead to better capital allocation, cost efficiencies, and improved margins, which could lead to a positive rerating of several small-cap names in the emerging market stock universe.

Berkeley Street Emerging Markets Small Cap

The Berkeley Street Emerging Markets Equity team employs a process-driven strategy of investing in quality small-cap companies at compelling prices. In any economy or sector, a small minority of companies generate most of the value. The team seeks to identify these companies. The team has been investing in small-cap companies using its quality-at-compelling-price process for its all-cap emerging market strategy since 2006. A standalone emerging market small-cap strategy was launched in 2018, allowing investors to benefit from an exclusive focus on small caps. The strategy aims to take advantage of several of the potential benefits of the asset class that we outlined above, with controlled levels of risk.

We believe that small-cap stocks in emerging markets can provide compelling returns while diversifying a traditional large- or all-cap allocation. We believe the compelling excess returns that small-cap emerging market managers have generated over multiple investment horizons is evidence of ongoing inefficiencies that active managers have been able to exploit. Emerging market small caps tend to demonstrate more volatility in drawdowns, though returns have been strong in market recoveries. Smaller companies also tend to have more domestically focused businesses with less exposure to supply chain disruptions or trade tensions than the larger companies in the space. We think this adds to the already-strong case to increase allocations to this asset class now.

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